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FILED

MAY 28 2008

Department of Insurance
State of Idaho

BEFORE THE DIRECTOR OF THE DEPARTMENT OF INSURANCE

STATE OF IDAHO

IN THE MATTER OF:

Gem State Insurance Company

Idaho Certificate of Authority: 1647
NAIC Company Code: 18457

)
)
) ORDER ADOPTING
) REPORT OF EXAMINATION
) AS OF DECEMBER 31, 2006
)
) Docket No. 18-2469-08
)
)
)
)

The Report of Examination as of December 31, 2006 (Report) of Gem State Insurance Company (Company) was completed by an examiner of the Idaho Department of Insurance (Department) and signed the 23rd day of May 2008 by the Examiner-in-Charge, David W. Emery, CFE, FLMI. The verified (attested) copy of the Report was filed with the Department effective May 23, 2008. Previously, a draft copy of the Report was delivered to the Company, with the verified Report being transmitted to the

Company electronically (PDF file, via e-mail) on May 23, 2008 to Mr. Robert B. Locke, Manager. The verified Report is attached hereto and incorporated herein as Exhibit A.


WAIVER

Attached hereto and incorporated herein as Exhibit B, is a Waiver signed by Mr. Locke on May 27, 2008 and received electronically by the Department on May 27, 2008 (via e-mail). Based upon the Waiver/Exhibit B, this is a final order, and the Company has waived its rights to seek reconsideration and judicial review of this order.

ORDER

NOW THEREFORE, after carefully reviewing the above described Report of Examination, attached hereto as Exhibit A, and good cause appearing therefor, it is hereby ordered that the above described report, which includes the findings, conclusions, comments and recommendations supporting this order, is hereby ADOPTED as the final examination report and as an official record of the Department under Idaho Code § 41-227(5)(a).

DATED and EFFECTIVE at Boise, Idaho this 28TH day of May 2008.



William W. Deal, Director
IDAHO DEPARTMENT OF INSURANCE

CERTIFICATE OF SERVICE

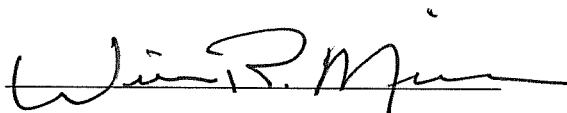
I hereby certify that on this 28th day of May 2008, I caused to be served the foregoing document on the following parties in the manner set forth below:

Mr. Robert B. Locke, Manager
Gem State Insurance Company
333 Main Street
Gooding, Idaho 83330-0236
BobLocke@cableone.net

<u> X </u>	certified mail
<u> </u>	first class mail
<u> </u>	hand delivery
<u> </u>	Facsimile
<u> X </u>	e-mail

Georgia Siehl, CPA, CFE
Bureau Chief / Chief Examiner
Idaho Department of Insurance
700 W. State St., 3rd Floor
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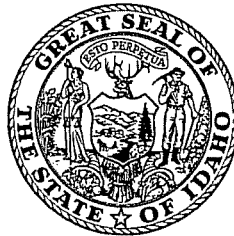
<u> </u>	certified mail
<u> </u>	first class mail
<u> X </u>	hand delivery
<u> </u>	facsimile
<u> X </u>	e-mail



William R. Michels, MBA, CPA, CFE
Examination Supervisor
IDAHO DEPARTMENT OF INSURANCE

DEPARTMENT OF INSURANCE

STATE OF IDAHO



REPORT OF EXAMINATION

of the

GEM STATE INSURANCE COMPANY

(NAIC Company Code 18457)

as of

December 31, 2006

FILED	<u>5/23/08</u>	<u>KL</u>
	date	initial
ADOPTED	<u>5/28/08</u>	<u>KL</u>
	date	initial
STATE OF IDAHO Department of Insurance		

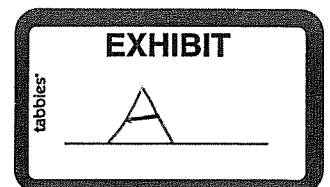


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State of Idaho
DEPARTMENT OF INSURANCE

C.L. "BUTCH" OTTER
Governor

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Phone (208)334-4250
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WILLIAM W. DEAL
Director

Gooding, Idaho
May 23, 2008

The Honorable William W. Deal
Director of Insurance
State of Idaho
700 West State Street
P. O. Box 83720
Boise, Idaho 83720-0043

Dear Director:

Pursuant to your instructions, in compliance with Idaho Code Section 41-219(1), and in accordance with generally accepted examination practices and procedures promulgated by the National Association of Insurance Commissioners (NAIC), we have conducted an examination as of December 31, 2006 of:

GEM STATE INSURANCE COMPANY

333 MAIN STREET
GOODING, IDAHO 83330

hereinafter referred to as "the Company," at its offices in Gooding, Idaho. Also the Idaho Department of Insurance is hereinafter referred to as the "Department."

The following Report of Examination is respectfully submitted.

SCOPE OF EXAMINATION

This examination covered the period January 1, 2002, through December 31, 2006. The examination was conducted at the Gooding, Idaho office of the Company by an examiner from the State of Idaho. The examination was conducted in accordance with Idaho Code Section 41-219(1), the National Association of Insurance Commissioners (NAIC) *Financial Condition Examiners Handbook*, and the NAIC *Accounting Practices and Procedures Manual*. We performed our testing in order to achieve a confidence level commensurate with the risk assessed through utilization of the NAIC *Examiners Handbook*. Verification and valuation of assets, determination of liabilities and reserves, and an analysis and review of such other accounts and records as appropriate to the examination were also performed.

A Letter of Representation was signed by the Company attesting to the Company's ownership of all assets and to the nonexistence of unrecorded liabilities or contingent liabilities.

The Company obtained a waiver for filing an audited CPA report for 2006. The examiner did, however, review the 2005 CPA audit report and key audit workpapers.

PRIOR EXAMINATION

The prior examination was conducted by the Idaho Department of Insurance, and covered the period of January 1, 1998 through December 31, 2001.

A review was made to ascertain what action was taken by the Company with regard to comments and recommendations made by the Department in the prior exam report. Unless otherwise mentioned in the COMMENTS AND RECOMMENDATIONS section of this report, the prior report exceptions were adequately addressed by the Company.

HISTORY AND DESCRIPTION

The Company was incorporated on March 10, 1910, as the Grange Mutual Co-Operative Fire Insurance Company of Idaho, and commenced operations in July of 1910. The initial purpose of the Company was to provide fire, lightning, hail, tornado and windstorm coverages for all "Patrons of Husbandry" (Grange members) who were affiliated with a subordinate Grange in the State of Idaho.

In 1984 the company was experiencing serious problems with loss of policyholders due to declining Grange membership, and the inability of the company to provide liability coverage with the property policies it was writing. At that time the company had adequate assets and surplus to convert from a county mutual to a domestic, which would allow writing personal and farm & ranch liability. That was accomplished, and in 1985 the company began writing those additional liability lines, along with property coverage, for all eligible property owners in Idaho, with no Grange membership requirement. The Company converted to a domestic mutual insurance company effective April 23, 1985. By amendment to the Articles of Incorporation, the name of Grange Mutual Fire Insurance Company of Idaho was adopted effective March 3, 1986.

Effective January 1, 1998, the name of the Company was changed from Grange Mutual Fire Insurance Company of Idaho to Gem State Insurance Company.

MANAGEMENT AND CONTROL

The management and control of the Company is guided by a Board of Directors consisting of five directors chosen from the members of the Company.

The annual meetings of the members and of the Board of Directors are held at the same location on the fourth Wednesday of April. Special meetings of the Board may be called by the President or upon the petition of any three board members, in accordance with provisions in the Bylaws.

Directors

The following persons were serving as directors at December 31, 2006:

<u>Name</u>	<u>Business Address</u>
Keith Skaar	Idaho Falls, ID
Steve Nielsen	Boise, ID
Mark Bulcher	Twin Falls, ID
Gordon Dailey	Moscow, ID
Douglas McEwan	Boise, ID

Officers:

The following persons were serving as officers at December 31, 2006:

Steve Nielsen	President
Keith Skaar	Vice President
Mark Bulcher	Secretary/Treasurer

Committees

The Bylaws provided for an Executive Committee consisting of three members, including the President of the Company. The committee shall act in compliance with the instructions of the Board, and within the limits of such power as may be transferred to, or withheld from the committee. An Investment Committee and a Compensation Committee were established by verbal instruction of the Board of Directors in 1997.

The following individuals were serving on the Executive, Investment and Compensation Committees as of December 31, 2006:

Executive Committee

Steve Nielsen
Douglas McEwan
Mark Bulcher

Investment Committee

Steve Nielsen
Douglas McEwan
Robert Locke

Compensation Committee

Steve Nielsen
Douglas McEwan
Keith Skaar

Conflict of Interest

The Company established conflict of interest procedures. These procedures required each of the directors, officers and office management personnel to complete a disclosure statement of any conflicts or possible conflicts with the performance of their duties and responsibilities on an annual basis. Disclosure statements completed by directors and officers during this examination period were reviewed and indicated no conflicts.

Contracts and Agreements

1. At December 31, 2006 the Company had one management agreement which is summarized as follows:

The Locke Agency (an insurance agency) of Gooding, Idaho serves as manager for the Company in accordance with the policies and directives of the Board of Directors to receive and accept proposals for contracts of insurance; to receive and receipt premiums; and to deliver policies of insurance to producers of the Company. The Locke Agency shall supervise and manage the insurance business for the Company including underwriting, servicing policies, processing claims, investments, reinsurance and all related functions. The Locke Agency shall maintain a fidelity bond covering all employees transacting insurance business for the Company and furnish sufficient office space, office equipment and personnel to adequately transact the business in an efficient manner.

The Company shall furnish file cabinets and computer equipment and reimburse the Locke Agency for its proportional share of maintenance and rental fees of a copy machine and postage meter. The Company will reimburse for postage, printing, supplies and telephone charges incurred on behalf of the Company, the portion of errors and omissions insurance obtained by the Locke Agency and the premium for the fidelity bond.

The Locke Agency shall receive as compensation for its services a monthly fee to be mutually determined by the Locke Agency and the compensation committee of the Company. The fee will be determined based on expense data provided to the Board of Directors within ninety days after the expiration of each calendar year of all amounts received and expended during the calendar year.

The agreement was effective April 28, 1999 and may be renewed for one-year periods upon mutual consent of the parties and upon terms and conditions agreed by the parties. Either party may terminate the agreement upon ninety days written notice.

The annual fee in 2006 was \$262,232.00. The agreement appeared fair and reasonable for the services provided. No Director and/or Officer of the Company had any interest in the Locke Agency.

2. The Company had one servicing agreement for the maintenance of their automated insurance processing system. In 2000 the Company purchased the automated insurance processing software from IMT Computer Services Company (IMT) of Des Moines, Iowa. The Company previously had a servicing agreement with IMT that included the software and technical support and training for a monthly fee. With the purchase of the software, the monthly service fee was reduced. IMT still provided updates and technical support and training for the reduced fee.

3. The Company entered into a contract in 2002 through ISO Passport to obtain claims information from A-PLUS and credit information from Transunion. The Company used these reports in its pre-approval process of accepting applications. This will be discussed further under "Treatment of Policyholders", later in this examination report.

CORPORATE RECORDS

Articles of Incorporation and Bylaws

Review of the Company's corporate file at the Department of Insurance for the period under examination indicated that the Bylaws were amended June 16, 1998 and approved by the Department of Insurance on June 29, 1998. The amendment changed Article VI – Meetings of Members – Section 1 to reflect the date

of the annual meeting of the members would be the fourth Wednesday in April each year. It also changed Article VII – Directors – Section 3 – Item 7 so the Directors would be allowed a reasonable rate of compensation for their services and reimbursement for reasonable expenses incurred in connection therewith.

On April 24, 2002 the members approved an amendment to the bylaws Article VI – Meetings of Members, Section 1 by adding, “The meeting shall be held at such place in Idaho as the secretary may fix.”

Minutes of Meetings

The minutes of the meetings of the Directors were reviewed for the period of examination. The minutes appear to adequately reflect the activities of the Company for the years 2002 through 2006. The Directors approved all investment activity as required by Idaho Code Section 41-704.

The Company had an Executive Committee, an Investment Committee and a Compensation Committee. There were NO minutes of these committees. It is recommended that the Company maintain minutes each time one of the committees meets. The manager indicated that he received confirmation for each investment transaction from one of the members of the Investment Committee prior to completing the transaction. The Company records reflected that this policy was followed.

The minutes reflected that the Company would appoint an actuary each year until 2005. Since the Company changed its actuary to Demotech, Inc, it has not appointed an actuary each year as required by the NAIC *Annual Statement Instructions*. It is recommended that the Company appoint an actuary annually, and document Board approval in the minutes.

The Minutes of the Directors meeting held April 23, 2003, indicated that the prior Report of Examination as of December 31, 2001 issued by the Idaho Department of Insurance was received and had been reviewed and approved by all Directors.

FIDELITY BOND AND OTHER INSURANCE

Insurance coverage for the protection of the Company had been maintained throughout the period under examination. Coverages in effect as of December 31, 2001, are summarized as follows:

The Company was protected by a fidelity bond that covers dishonest or fraudulent acts by employees up to \$250,000 (single loss and aggregate) with a single loss deductible of \$1,000. The fidelity bond coverage met suggested minimum limits recommended by the NAIC Financial Condition Examiners Handbook.

The Company was covered for Business Property, Directors & Officers Liability, and Workers' Compensation.

The insurance companies providing the coverages to the Company were authorized insurers in the State of Idaho. The certification signed by management acknowledged that no losses had been suffered due to dishonest or fraudulent acts.

As previously reported, the Locke Agency was required to maintain a fidelity bond covering all employees transacting insurance business on behalf of the Company in an amount at least equal to the recommendations of the NAIC. It was noted that the Locke Agency employees acting on behalf of the Company would be covered by the Company's fidelity bond.

PENSION AND INSURANCE PLANS

The personnel who performed the duties of the Company are employees of the Locke Agency, with the exception of the Agency Administrator. The Company provided a group life and accidental death plan which covered all of the Locke Agency personnel involved with Company operations, the Agency Administrator, and the Directors and officers of the Company. The Company also provided a key-man life insurance policy for the manager with the Company as the owner and named beneficiary.

TERRITORY AND PLAN OF OPERATION

The Company was licensed only in the State of Idaho as a domestic property and casualty insurer, and the business written was primarily comprehensive homeowners policies (including small farming operations), and fire protection on small commercial properties.

Operations of the Company were conducted on an agency basis with approximately 50 producers under contract. The commission schedule in current use appeared to be reasonable. A bonus plan based on experience had been in effect since 1990.

The Company had maintained its home office in Gooding, Idaho, since 1918, and all insurance operations are performed at that location.

STATUTORY AND SPECIAL DEPOSITS

As of December 31, 2006, the Company provided the following securities in trust for the benefit of policyholders or policyholders and creditors, through the office of the Director of Insurance, State of Idaho:

<u>Description</u>	<u>Par Value</u>	<u>Statement Value</u>	<u>Market Value</u>
Banco Bilbao Vizcay Time CD	\$ 100,000	\$ 100,000	\$ 100,000
North Georgia Bank CD	115,000	115,000	115,000
Discover Bank TCD	100,000	100,000	100,000
First Bank of Puerto Rico CD	100,000	99,500	100,000
Old National Bank TCD	40,000	40,000	40,000
FHLB	65,000	65,000	63,964
Bank of Idaho TCD	100,000	100,000	100,000
Independent Bank TCD	97,000	97,000	97,000
Key Bank TCD	97,000	97,000	97,000
Lehman Brothers Bank TCD	100,000	100,000	100,000
Midfirst Bank CD	<u>100,000</u>	<u>100,000</u>	<u>100,000</u>
Totals	<u>\$1,014,000</u>	<u>\$1,013,500</u>	<u>\$1,012,964</u>

The deposit meets the general requirements and provisions of Idaho Code Sections 41-316A, 41-803 and 41-804. The deposit was verified by the Idaho Department of Insurance.

GROWTH OF THE COMPANY

The Company's Growth for the years indicated, as taken from its Annual Statements (or as adjusted by the examination report) is shown in the following schedule:

<u>Year</u>	<u>Admitted Assets</u>	<u>Liabilities</u>	<u>Surplus</u>	<u>Net Income</u>
2001 *	\$4,077,996	\$1,101,168	\$2,976,828	\$179,819
2002	4,451,634	1,423,541	3,028,093	128,076
2003	5,383,012	1,948,255	3,434,757	309,197
2004	5,594,083	1,947,121	3,646,922	163,464
2005	6,146,516	2,040,383	4,106,132	417,858
2006 *	\$6,437,121	\$1,983,908	\$4,453,213	\$268,266

* As determined by Examination

LOSS EXPERIENCE

The ratios of losses and underwriting expenses incurred to premiums earned, as reported in the Company's annual statements for the five year period ending December 31, 2006 are reported below:

<u>Year</u>	<u>Premiums Earned</u>	<u>Losses Incurred</u>	<u>Loss/UW Expenses Incurred</u>	<u>Total Losses & Expenses</u>	<u>Ratio to Premiums Earned</u>
2001	\$1,221,386	\$ 667,204	\$547,772	\$1,216,976	99.6%
2002	1,379,039	816,658	594,629	1,411,287	102.3%
2003	1,777,822	988,020	621,006	1,609,026	90.5%
2004	2,027,136	1,338,783	749,486	2,088,269	103.0%
2005	2,276,208	1,210,215	821,045	2,031,260	89.2%
2006	\$2,330,147	\$1,382,853	\$907,409	\$2,290,262	98.3%

REINSURANCE

At December 31, 2006 the Company ceded business through General Reinsurance Corporation, a Delaware domiciled company that is authorized to transact business in the State of Idaho.

The agreement contained an excess of loss of Personal Property Business, Personal Liability Business and Personal Property Business Catastrophe Coverage. Personal Property Business is defined as fire (dwelling fire), allied lines (personal only), inland marine (personal only), homeowners multiple peril (property coverages) and farmowners multiple peril (property coverages). Personal Liability Business is defined as section II under homeowners multiple peril, section II under farmowners multiple peril and comprehensive personal liability. Personal Property Business Catastrophe Coverage provides recoveries on catastrophic losses that exceed retention limits of \$100,000 plus 5% of the next \$900,000. Personal Property Business is defined as insurance against fire (dwelling fire), allied lines (personal only), inland marine (personal only), homeowners multiple peril (property coverages) or farmowners multiple peril (property coverages).

The following schedule reflects the amounts of retention for the Company:

	<u>Company Retention</u>	<u>Reinsurance Retention</u>	
		<u>1st Cover</u>	<u>2nd Cover</u>
Excess Loss Personal Liability	\$50,000	\$50,000	\$900,000
Excess Loss Personal Property	\$50,000	\$50,000	\$650,000

Excess Loss Personal Property (Catastrophe)	\$200,000 of Ultimate Net Loss	the next amount of ultimate net loss, but not exceeding \$1,250,000 each loss occurrence
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The reinsurance premiums are a percentage of the Company's subject written premium as reflected in the following schedule. The reinsurance premium is subject to a fixed commission allowance as also reflected in the following schedule.

	<u>Reinsurance Premiums</u>		<u>Commission</u>
	<u>1st Cover</u>	<u>2nd Cover</u>	
Excess Loss Personal Liability	18.18%	23.85%	34.0%
Excess Loss Personal Property	15.3%	19.39%	34.0%
Excess Loss (Catastrophe)	1.89% with \$60,375 deposit Premium and \$48,300 minimum Premium		

The reinsurer shall maintain the required reserves and the Company is liable for all premium taxes. There is a right to offset any balances provision between the Company and the reinsurer. The Agreement contains an acceptable insolvency clause, arbitration and errors and omissions clauses and standard exclusions.

The agreement was effective July 1, 2004 and perpetual until either party is notified not less than 90 days by registered mail of the stated date and time when the agreement will be terminated. Upon termination, the reinsurer shall not be liable for claims or losses resulting from occurrences taking place after the effective time and date of termination. In such event, the reinsurer shall return to the Company the reinsurance premium unearned, calculated on the monthly pro rata basis as of the time of the effective time and date of termination.

The consulting actuary for the Department, Taylor-Walker and Associates, reviewed the reinsurance agreements and found that the contracts provide for timely payment of premiums and claims. Therefore, timing risk is satisfied. Also, based on the premium rates and reinsurance exposure to losses, underwriting risk is present in the agreements, as defined in SSAP 62. Therefore, reinsurance accounting is appropriate for the agreements.

INSURANCE PRODUCTS AND RELATED PRACTICES

Policy Forms and Underwriting Practices

The Company utilized four basic policy forms in writing its homeowners, small farming operations, small commercial properties and renters coverages. A review of these forms revealed the use of standard AAIS forms along with several other forms filed with the Department of Insurance. Premium rates and servicing fees in effect were contained in the Company's rate manual, along with other general information regarding underwriting and policy issues.

Producers appointed by the Company have binding authority on dwelling and farm risks subject to those risks meeting the Company underwriting guidelines and do not exceed the \$650,000 per risk limit.

The Company retains \$50,000 per risk and cedes the excess with General Reinsurance Corporation.

Treatment of Policyholders

Claims:

A sample of claims as of December 31, 2006 was reviewed during the course of this examination. The review indicated that the claims were being settled properly and that payments were being made in a timely manner.

Complaints:

The Company maintained a complaint register. It was determined that the complaint register did contain a complete record of all complaints that the Company had received since the date of its last examination as prescribed by Idaho Code Section 41-1330. The Company had a fraudulent claim procedure in place, in compliance with Idaho Code Section 41-290.

Credit Scoring:

A limited scope review of the Company's credit scoring policies was conducted. As mentioned earlier, the Company had a contract through ISO Passport to obtain claims information from A-PLUS and credit information from Transunion. The Company used these reports in its pre-approval process of accepting applications. According to the Company's underwriting guidelines (a.k.a. Rates and Rules) supplied to producers, a pre-approval form/checklist, itemizing various underwriting variables (including a credit score), may be completed prior to binding coverage on a new customer. Following discussions with the Company, however, it was determined that the pre-approval form is not retained either electronically or in paper form. Additionally, there apparently is no other documentation retained which identifies the weighting of credit and non-credit factors considered in the declination of a policy.

According to IDAPA 18.01.19 if a company uses credit as a factor, a company "*must be able to show*" that it relied upon non-credit factors at least as much as credit factors (i.e. credit cannot be weighted greater than 50%) in decisions to: 1) decline to issue a policy, 2) non-renew a policy, 3) cancel a policy, 4) establish initial rate for new business, or 5) increase premium rate.

The Company's information system was not set-up to retain documentation that demonstrated compliance with IDAPA 18.01.19.100.02.a, specifically as it related to declination of policies during the examination period. With regard to declination of policies, it is recommended that the Company retain the information contained on the pre-approval form and summarize what factors (credit and non-credit) the declination relied upon, as well as the weighting of the decision factors. It is also recommended that the Company include a policy, or instructions in its underwriting guidelines that require the retention of the aforementioned documentation to show compliance with IDAPA 18.01.19. These recommendations were discussed with the Company during the examination fieldwork, and Company management has agreed to their implementation.

Advertising and Sales Materials

The Company did a minimal amount of advertising during the period under examination, and did not utilize radio or television in its business promotion. Occasionally, the Company distributes promotional items bearing its name and logo.

ACCOUNTS AND RECORDS

General Accounting

The Company utilized computerized accounting software maintained by IMT to generate accounting and financial information. The Company maintained a hand posted set of books for reconciliation between GAAP and SAP accounting for the annual statement.

Independent Accountants

The annual independent audits of the Company for years 2002 through 2005 were performed by:

Jones, Spackman, Basterrechea & France, Chtd.
714 Main Street
Gooding, Idaho 83330

The independent auditor's reports were based on statutory accounting principles.

As mentioned earlier, the Company obtained a waiver for filing an audited CPA report for 2006. The examiner did, however, review the 2005 CPA audit report and key audit workpapers.

Actuarial Opinion

The loss and loss adjustment reserves and related liabilities were calculated by the Company and reviewed by Joseph L. Petrelli, consulting actuary with Demotech, Inc. of Dublin, Ohio. The actuary using standard actuarial procedures then determined the incurred loss reserves and issued a statement of opinion. The opinion stated that the amounts of the reserves:

- a. meet the requirements of the insurance laws of Idaho;
- b. are consistent with reserves computed in accordance with accepted actuarial standards and principles;
- c. make a reasonable provision for all unpaid loss and loss expense obligations of the Company under the terms of its contracts and agreements.
- d. do not require a provision for the unearned premium reserves for long duration contracts of the Company under the terms of its contracts and agreements.

The identified actuarial items are listed as follows:

Note: Pages and schedules referenced below pertain to the 2006 Annual Statement.

Loss Reserves

A Reserves for Unpaid Losses (Page 3, Line 1)	\$285,315
B Reserve for Unpaid Loss Adjustment Expenses (Page 3, Line 3)	\$ 92,523
C Reserve for Unpaid Losses – Direct and Assumed (Schedule P-Part 1, Total of Columns 13 and 15)	\$647,000
D Reserve for Unpaid Loss Adjustment Expenses – Direct and Assumed (Schedule P-Part 1, Total of Columns 17, 19, and 21)	\$118,000
E Retroactive Reinsurance Reserve Ceded or Assumed (Page 3, Write-in Item)	Not Applicable
F Other Loss Reserve Items	Not Applicable

Premium Reserves

G Reserve for Direct and Assumed Unearned Premiums for Long Duration Contracts	Not Applicable
H Reserve for Net Unearned Premiums for Long Term Duration Contracts	Not Applicable
I Other Premium Reserve Items	Not Applicable

The following were taken into consideration in determining the above amounts:

1. Materiality Standard expressed in \$US	\$222,661
2. Statutory Surplus	\$4,453,213
3. Anticipated net salvage and subrogation included as a reduction to loss reserves as reported in Schedule P	\$0
4. Discount included as a reduction to loss reserves and loss expense reserves as reported in Schedule P	
4(a) Nontabular Discount	Not Applicable
4(b) Tabular Discount	Not Applicable
5. The net reserves for losses and expenses for the Company's share of voluntary and involuntary underwriting pools' and associations' unpaid losses and expenses that are included in reserves shown on the Liabilities, Surplus and Other Funds page, Losses and Loss Adjustment Expenses lines.	\$0
6. The net reserves for losses and loss adjustment expenses that the Company carries for the following liabilities included on the Liabilities, Surplus and Other Funds page, Losses and Loss Adjustment Expenses lines.	
6(a) Asbestos, as disclosed in the Notes to Financial Statements	Not Applicable
6(b) Environmental, as disclosed in the Notes to Financial Statements	Not Applicable
7. The total claims made extended loss and loss expense reserves (Schedule P Interrogatories)	
7(a) amount reported as loss reserves	\$0
7(b) amount reported as unearned premium reserves	\$0
8. Other items	Not Applicable

See the "NOTES TO FINANCIAL STATEMENTS" section, later in this report, for discussion of the Department's examining actuaries' analysis.

SUBSEQUENT EVENTS

On April 23, 2008, the Company held its Annual Policyholders Meeting. During the meeting, the Bylaws Article VI – Meetings of Members, Section 1 was amended to change the date of the Annual Policyholders Meeting from the 4th Wednesday in April to the 3rd Wednesday in April.

FINANCIAL STATEMENTS

The financial section of this report contains the following statements:

- Assets as of December 31, 2006
- Liabilities, Surplus and Other Funds as of December 31, 2006
- Statement of Income, For the Year Ending December 31, 2006
- Capital and Surplus Account, For the Year Ending December 31, 2006
- Reconciliation of Capital and Surplus, December 31, 2001 through December 31, 2006

ASSETS
As of December 31, 2006

	<u>Ledger</u>	Non <u>Admitted</u>	Net <u>Admitted</u>
Bonds (Note 1)	\$2,749,232	\$ 0	\$2,749,232
Preferred Stock (Note 2)	506,670	0	506,670
Common Stock (Note 2)	916,112	0	916,112
Real Estate – Occupied by the Company	0	0	0
Cash and Short term Investments (Note 3)	2,070,790	0	2,070,790
Receivable for Securities	0	0	0
Investment Income Due and Accrued	83,796	0	83,796
Premiums in Course of Collection	0	0	0
Premiums deferred and not yet due	103,735	0	103,735
Amounts Recoverable from Reinsurers	0	0	0
Net Deferred Tax Asset	0	0	0
Electronic Data Processing Equipment	0	0	0
Furniture and Equipment	<u>6,786</u>	<u>0</u>	<u>6,786</u>
Total Assets	<u>\$6,437,121</u>	<u>\$ 0</u>	<u>\$6,437,121</u>

LIABILITIES, SURPLUS AND OTHER FUNDS
As Of December 31, 2006

Losses (Note 4)	\$ 285,315
Loss Adjustment Expenses (Note 4)	92,523
Commissions Payable	77,254
Other Expenses	24,310
Taxes, licenses and fees	2,901
Current federal income taxes	6,592
Net deferred tax liability	16,609
Unearned premiums	1,274,367
Ceded reinsurance premiums payable	203,732
Amounts withheld or retained by company	(81)
Payroll tax withholding	<u>386</u>
Total Liabilities	<u>\$1,983,908</u>
Unassigned funds (surplus)	<u>\$4,453,213</u>
Total Surplus	<u>4,453,213</u>
Total Liabilities, Surplus and Other Funds	<u>\$6,437,121</u>

STATEMENT OF INCOME
For The Year Ending December 31, 2006

<u>Underwriting Income</u>	
Premiums earned	\$ 2,330,147
Deduct:	
Losses Incurred	\$1,382,853
Loss Expenses Incurred	190,151
Other Underwriting Expenses Incurred	693,836
Reinsurance Cont Commission	23,422
Total Underwriting Deductions	<u>\$2,290,262</u>
Net Underwriting Gain (Loss)	<u>\$ 39,885</u>
<u>Investment Income</u>	
Net Investment Income Earned	\$ 348,658
Net Realized Capital Gains (Losses)	<u>(7,894)</u>
Net Investment Gain (Loss)	<u>\$ 340,764</u>
<u>Other Income</u>	
Net Gain (Loss) from Agents' or Premium Balances Charged Off	\$ 0
Miscellaneous Income (Loss)	<u>9,666</u>
Total Other Income	<u>\$ 9,666</u>
Net Gain From Operations Before Dividends and Federal Income Taxes	\$ 390,315
Dividends to policyholders	<u>0</u>
Net Gain (Loss) From Operations After Dividends and Before Federal Income Taxes	\$ 390,315
Federal Income Taxes Incurred	<u>122,049</u>
Net Income (Loss)	<u>\$ 268,266</u>

CAPITAL AND SURPLUS ACCOUNT
For the Year Ending December 31, 2006

Surplus, December 31, 2005	\$4,106,132
Net Income (Loss)	\$ 268,266
Net Unrealized Capital Gain (Losses)	87,293
Change in net deferred income tax	(15,231)
Change in non-admitted assets	6,753
Other Adjustments	<u>0</u>
Net change in surplus for the year	<u>\$ 347,081</u>
Rounding	0
Surplus, December 31, 2006	<u>\$4,453,213</u>

RECONCILIATION OF CAPITAL AND SURPLUS
December 31, 2001 through December 31, 2006

	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>
Prior Year Surplus, December 31	<u>\$2,976,828*</u>	<u>\$3,028,093</u>	<u>\$3,434,757</u>	<u>\$3,646,922</u>	<u>\$4,106,132</u>
Net income	128,076	309,197	163,464	417,858	268,266
Change in unrealized gains (losses)	(137,575)	189,256	38,577	18,306	87,293
Change in net deferred income tax	101,148	(117,208)	53,876	29,800	(15,231)
Change in non-admitted assets	0	0	0	(6,753)	6,753
Other Adjustments	<u>18,334</u>	<u>25,419</u>	<u>(43,752)</u>	<u>0</u>	<u>0</u>
Net Change for the Year	<u>\$ 51,267</u>	<u>\$ 406,664</u>	<u>\$ 212,165</u>	<u>\$459,211</u>	<u>\$347,081</u>
Rounding	(2)	0	0	(1)	0
Current Year Surplus, December 31	<u>\$3,028,093</u>	<u>\$3,434,757</u>	<u>\$3,646,922</u>	<u>\$4,106,132</u>	<u>\$4,453,213*</u>

* Per Examination

NOTES TO FINANCIAL STATEMENTS

Bonds (Note 1)

\$2,749,232

During the examination period the Company had a steady growth in its bonds. They increased from \$2,077,216 in 2002 to \$2,749,232 in 2006. The Company has mainly U. S. government bonds. The Company listed all of its bonds with an NAIC designation of "1" and the preferred stocks as a "P1A". Several of these bonds and preferred stocks should also show an "FE" designation. The Company should obtain a listing from either its custodian or broker showing the current rating from a recognized rating bureau (Moody's, Standard & Poor's, etc.) or obtain the information from the NAIC Securities Valuation Office CD. It is recommended that the Company maintain a listing showing a current rating from a recognized rating bureau or obtain the NAIC Securities Valuation Office CD and report its securities according to the NAIC Securities Valuation Office instructions.

A review of the general custodial agreement showed that the agreement does not state that in case of termination, the bank will notify the Director of the Department of Insurance within ten days of the termination. This was brought to the Company's attention and during the examination the Company obtained an amendment to the custodial agreement correcting this.

Preferred Stock (Note 2)

\$506,670

Common Stock (Note 2)

\$916,112

The Company invested in both preferred and common stock. The total stock portfolio had a steady increase from year to year. In 2002 the Company had \$786,777 and in 2006 it had \$1,422,782. The Company did not have any stock in excess of that allowed by Idaho Code Section 41-714. See the above section "Bonds" regarding the Company's use of NAIC designations for preferred stock and the associated recommendation.

Cash and Short-term Investments (Note 3)

\$2,070,790

The Company had \$1,581,200 in its checking accounts and CD's, and short term investments of \$489,590. These amounts were properly reported on Schedule DA, Part 1 and Schedule E, Part 1 of the 2006 Annual Statement.

Losses (Note 4)

\$285,315

Loss Adjustment Expenses (Note 4)

\$ 92,523

The actuarial portion of the examination was conducted for the Idaho Department of Insurance by R. Glenn Taylor, ACAS, MAAA and Randal D. Ross, ACAS, MAAA of the firm Taylor-Walker & Associates, Inc. Based upon the examining actuaries' final report and supporting analyses, the Company's 2006 Annual Statement was within the examination indicated reasonable range of reserves. Therefore, there were no recommend adjustments to the Company's booked loss and LAE reserves.

The Company's potential liability for premium deficiency reserves was also reviewed based on the estimates of ultimate losses and LAE. A review of historical loss and expense ratios did not indicate that such a reserve should be established.

SUMMARY, COMMENTS AND RECOMMENDATIONS

Summary

The results of the examination disclosed that as of December 31, 2006, the Company had admitted assets of \$6,437,121, liabilities of \$1,983,908, and surplus as regards policyholders of \$4,453,213. The Company was in compliance with the minimum capital and surplus requirements of Idaho Code Section 41-313.

There were no examination adjustments made on any of the balance sheet accounts. Thus the unassigned funds balance of \$4,453,213, as reported by the Company remained unchanged.

Comments and Recommendations

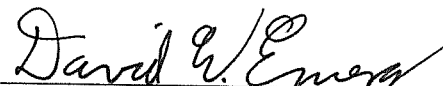
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- | | |
|----|---|
| 5 | <u>Minutes of Meetings</u> It is recommended that the Company maintain minutes each time one of the committees meets. |
| 5 | <u>Minutes of Meetings</u> It is recommended that the Company appoint an actuary annually, and document Board approval in the minutes. |
| 9 | <u>Credit Scoring</u> It is recommended that the Company retain the information contained on the pre-approval form and summarize what factors (credit and non-credit) the declination relied upon, as well as the weighting of the decision factors. |
| 9 | <u>Credit Scoring</u> It is also recommended that the Company include a policy, or instructions, in its underwriting guidelines that require the retention of the aforementioned documentation to show compliance with IDAPA 18.01.19. |
| 16 | <u>Bonds</u> It is recommended that the Company maintain a listing showing a current rating from a recognized rating bureau or obtain the NAIC Securities Valuation Office CD and report its securities according to the NAIC Securities Valuation Office instructions. |

CONCLUSION

The courteous assistance and cooperation extended by the Company's Manager and staff during the course of this examination is acknowledged and appreciated.

Respectfully submitted,

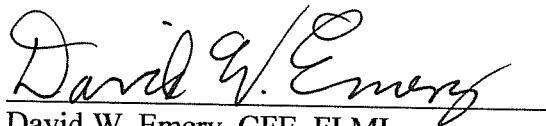


David W. Emery, CFE, FLMI
Senior Insurance Examiner
Department of Insurance
State of Idaho

AFFIDAVIT OF EXAMINER

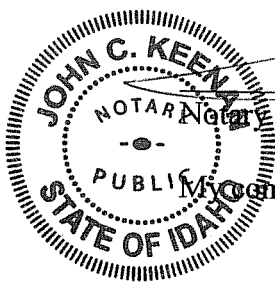
State of Idaho
County of Ada

David W. Emery, being duly sworn, deposes and says that he is a duly appointed Examiner for the Department of Insurance of the State of Idaho, that he has made an examination of the affairs and financial condition of the Gem State Insurance Company for the period from January 1, 2002 through December 31, 2006, including subsequent events, that the information contained in the report consisting of the foregoing pages is true and correct to the best of his knowledge and belief, and that any conclusions and recommendations contained in the report are based on the facts disclosed in the examination.



David W. Emery, CFE, FLMI
Examiner-in-Charge
Department of Insurance
State of Idaho

Subscribed and sworn to before me the 23RD day of MAY, 2008 at Boise, Idaho





My Commission Expires: 30 OCT 2013

C.L. "BUTCH" OTTER
Governor

State of Idaho
DEPARTMENT OF INSURANCE

700 West State Street, 3rd Floor
P.O. Box 83729
Boise, Idaho 83729-0043
Phone (208)334-4250
FAX # (208)334-4398

WILLIAM W. DEAL
Director

WAIVER

In the matter of the Report of Examination as of December 31, 2006, of:

**Gem State Insurance Company
333 Main Street
Gooding, Idaho**

By executing this Waiver, the Company hereby acknowledges receipt of the above-described examination report, verified as of the 23rd day of May 2008, and by this Waiver hereby consents to the immediate entry of a final order by the Director of the Department of Insurance adopting said report without any modifications.

By executing this Waiver, the Exchange also hereby waives:

1. its right to examine the report for up to thirty (30) days as provided in Idaho Code section 41-227(4),
2. its right to make a written submission or rebuttal to the report prior to entry of a final order as provided in Idaho Code section 41-227(4) and (5),
3. any right to request a hearing under Idaho Code sections 41-227(5) and (6), 41-232(2)(b), or elsewhere in the Idaho Code, and
4. any right to seek reconsideration and appeal from the Director's order adopting the report as provided by section 41-227(6), Idaho Code, or elsewhere in the Idaho Code.

Dated this 27th day of May, 2008

Robert B. Locke

Name (print)

Robert B. Locke

Name (signature)

Title

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STATE OF IDAHO
DEPT OF INSURANCE

Equal Opportunity Employer

EXHIBIT

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